# DOW THEORY LETTERS INC.

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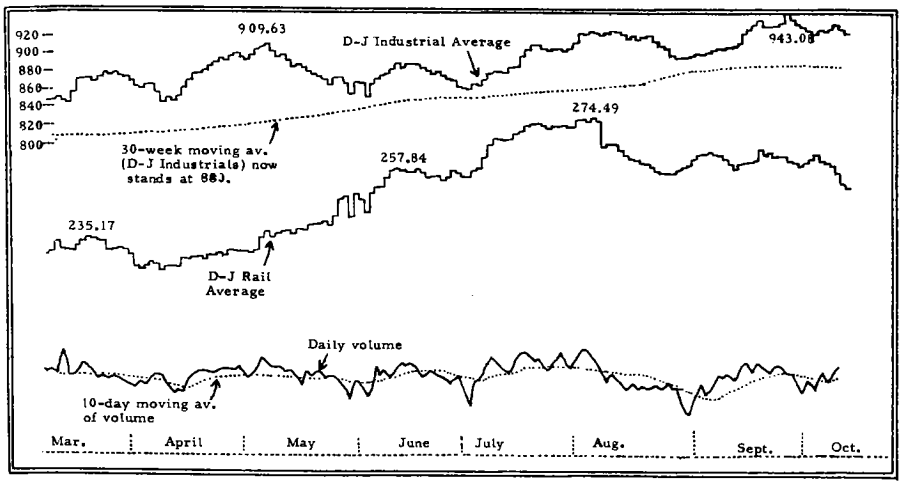
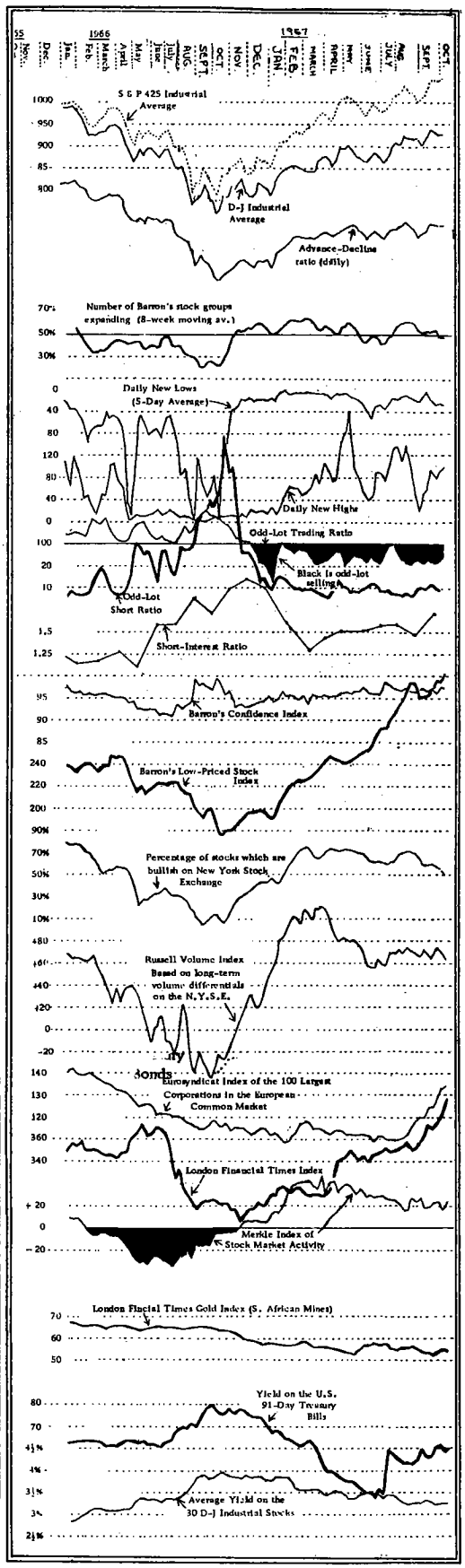
THE MARKET: A glance at the Composite Chart on page 1 might be instructive at this time. Although a number of the price indices are at or near their highs (Low-Priced Stocks, London Stock Index, Industrial Average), many of the technical indicators which measure the market's underlying strength have passed their peaks. For instance, the advance-decline ratio struck its high on August 2, more than two months ago. Two days later (August 4) the two Averages, Rails and Industrials, touched their last confirmed highs. The number of Barron's stock groups expanding reached its peak ten weeks ago. The number of daily new highs hit its peak way back in May (this despite higher prices since on the Dow). The Russell Volume Index topped out in March, and its recent rally from the May low was unimpressive. The very accurate Merkle Index of stock market activity climbed to its peak in March, and it has been trailing lower ever since (although it is still above the critical zero level).

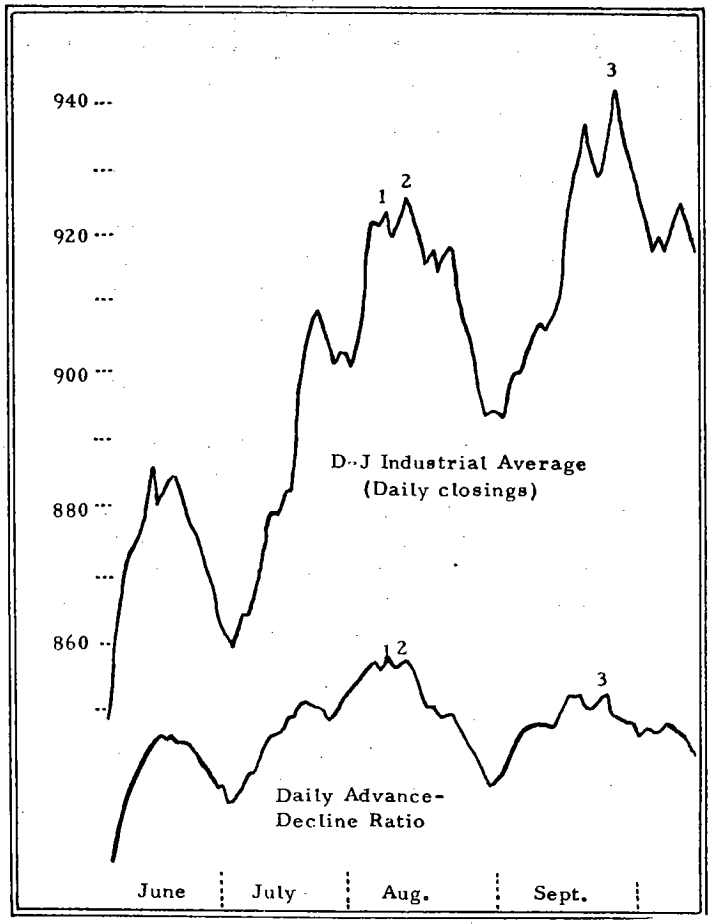
All in all, this run-down suggests to me that this market is slowly moving into the "trouble zone," and it would take a major injection of new technical strength to reverse the negative path we are now following. Considering (as I do) that this is a rally in a primary bear market, I am extremely dubious of the probability of a renewed build-up of the technical factors.

One characteristic of the current market is weakness in breadth, and this was commented upon in the past two Letters. For instance, on days when the Industrial Average advances (usually on increasing volume) the plurality of issues advancing has been minimal, with perhaps 50 to 100 more issues rising than declining. But on days when the Industrial Average declines (and this has generally occurred on contracting volume) many more issues decline than advance. This is poor action, and it is reflected in that rather flat portrait on the advance decline ratio as compared to the Industrial Average (see chart). Thus we have a high in the advance-decline ratio established August 2, with a further series of new highs on the Industrial Average, each unconfirmed by the advance-decline ratio. As I see it, the A-D ratio is "saying" that although the Industrial Average is still in a





S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index Based on long-term volume differentials on the N.Y.S.E.
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fincial Times Gold Index (S. African Mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

generally advancing stage, this advance since August 2, has not been sustained by the rest of the market. Therefore, I consider it important to watch the breadth carefully during the period ahead. The ability or inability of breadth to confirm may hold the key to action on Wall Street between now and the end of the year.

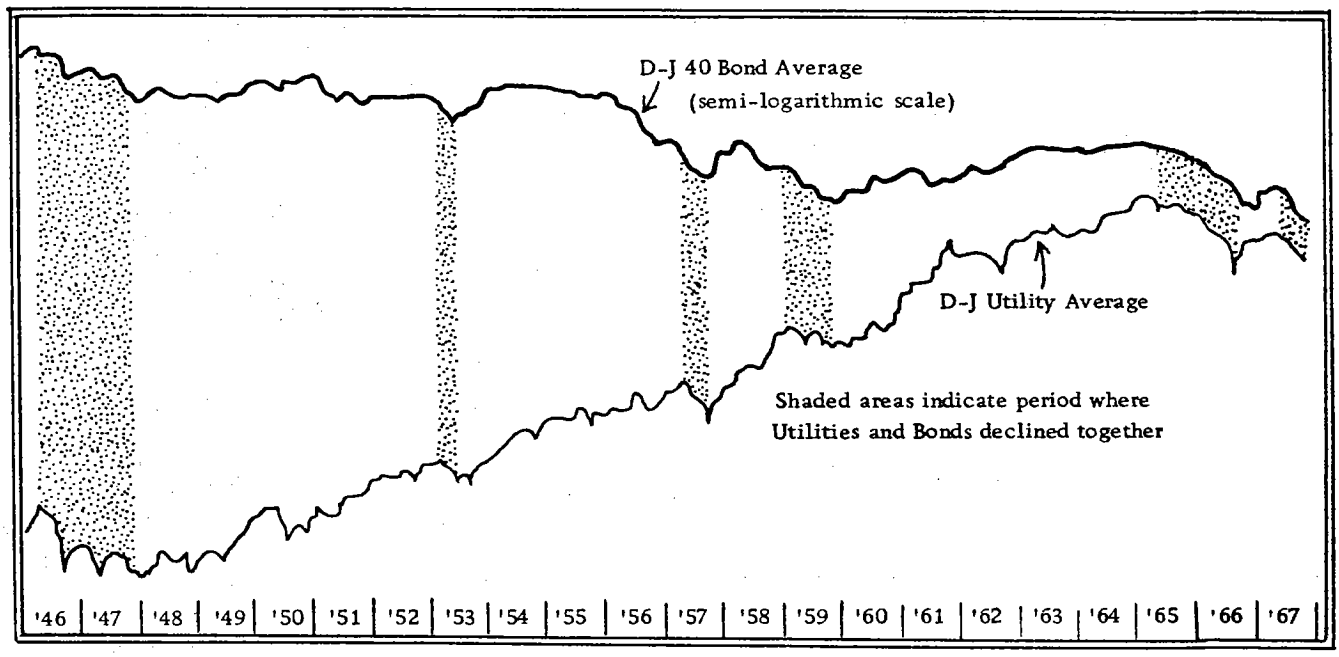



Perhaps the most extraordinary aspect of all is the parting of the ways in the paths of the Industrial and Rail Averages. Industrials struck a recovery high of 943.08 on September 25, but Rails failed by a wide margin (see page 1 chart) to confirm. A Rail confirmation would have entailed a Rail bettering of the August 4 high of 274.49. Following the Rail non-confirmation, the two Averages entered upon a divergent path with Industrials rallying since early October while Rails sank persistently to lower levels. On October 11 the Rail Average cracked below the August lows of 258.07, thereby taking the carriers to the lowest level since mid-June. Thus the two Averages have not only produced an important non-confirmation, but they have developed serious divergent tendencies.

Past history suggests that persistent divergence in the Averages is usually followed by violent movements—with the two indicators always "getting in gear" one way or the other. If the weakness in the Rails is the more pronounced trend, we can expect Industrials to follow the Rails down—and soon. Conversely, if the strength in Industrials is the more persistent trend, we can shortly expect the carriers to reverse their path to the upside. In my opinion, the failure of Rails to confirm plus the further decline in Rails (despite the late Industrial rally) suggests that the (downward) Rail trend is stronger than the (upward) Industrial trend. The answer should be given by the market soon, perhaps in a matter of days.

DANGER SIGNALS CONTINUE: Two weeks ago the comprehensive D-J 40-Bonds cracked the 79 level for the first time in 33 years. In his booklet, "Stock Market Timing," leading market analyst Daniel Merkle states: "'Intelligent capital seeks safety first of all.' This principle is the secret of the D-J 40 Bond Average, which has proved to be a valuable indicator for generations. Consistently it has led market turns by many months."

I have included many studies of the 40-Bonds, and I have improved this indicator by using it in conjunction with the D-J Utility



DISAPPROVAL: Over the past three years I have repeatedly voiced my opinion regarding the mess in Vietnam. I have always seen the war as part of the economic battle of communism against capitalism, and more specifically China's and Russia's battle against the U.S. I believe that the U.S.(particularly under the "leadership" of LBJ) has fallen neatly into the trap. The war has cost over $75 billion; as such it probably represents the greatest waste of capital the world has ever seen. With the war fiasco in full array, President Johnson's "popularity" has finally collapsed.

You can fool all the people some of the time but you can't fool them all the time. A recent poll of President Johnson's popularity underscores those wise words of President Lincoln's. According to the latest poll, over 60% of the American people now disapprove of the way LBJ is carrying out his office (and this dissatisfaction is focussed mostly on Vietnam) while less than 40% now approve of LBJ's efforts.

Support for the conduct of the war is eroding in the Senate, particularly so over the past month. As the sentiment of the American people becomes more clear, it is probable that many politicians will do an about-fact. General Gavin, one of the few potential political thinkers around, is now being advanced as a 1968 Presidential candidate. Gavin wants the war contained or settled.

The continuance of the war has enormous economic significance. The war was a major unspoken issue at the recent, fuzzy meeting of the International Monetary. Fund in Rio. The Vietnam war is extremely unpopular with most of the Free World. They consider it a fatuous U.S. blunder, calculated to wreck the monetary system of the West. According to the Christian Science Monitor (Oct. 5) in an interview with economist Robert Triffin, "Western Europeans will grow tired of 'financing' the Vietnam war for the U.S. by accepting dollars into their reserves. The war is unpopular in much of Europe."

With the pigeon-holing of President Johnson's proposed 10% surtax, the financing of the war (at least for the time being) will have to be conducted in the money markets. This means a coming U.S. deficit of probably $30 billion or better and forthcoming huge offerings of bills, notes and bonds. It's all such a staggering mess that it boggles the mind of the average man. How can you get excited about a $30 billion budget deficit? It's like getting excited about a potential collision between two planets. It's too big to comprehend, too impersonal to get excited about, too absurd to become emotional over. But it is going to happen, and nothing that I see coming up is calculated to stop it. Welcome to financial dreamland, fellow Americans.

Average. It has been my observation that whenever these two indices, the 40-Bonds and the D-J Utility Average, head into pronounced downtrends, the bearish forces which have contributed to those downtrends will shortly affect the entire stock market.

For this reason it is particularly important to note that on October 3 the Utility Average broke to a fresh new low for the year, its lowest level since mid-1966. Thus not only are the Utilities and Bonds now in definite downtrends, but as of last week both indices broke to new lows. Those joint lows have continued day after day.

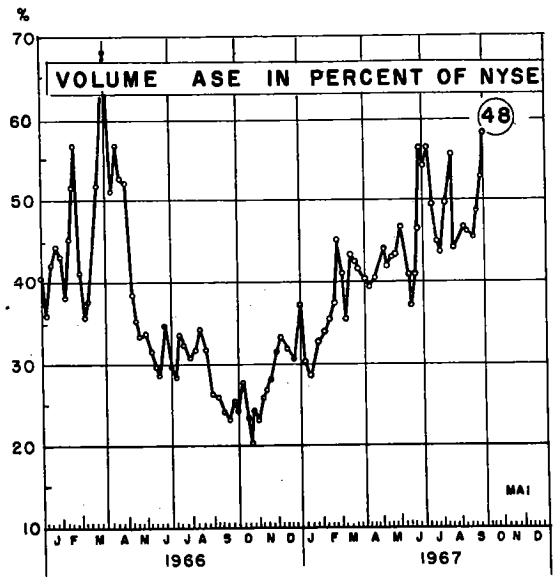
I include a chart showing the path of the Utilities and Bonds since the year 1946. Note the six shaded areas. These areas denote periods in which both Utilities and Bonds were in definite downtrends. Each such area was marked by weakness in stock prices. The latest shaded area started in February, 1967, but so far, the weakness as shown on the chart has not spread to the general market. I believe that it will, however, and the only factor which has held back the potential weakness, so far, is the public's acceptance of the theory that inflation and higher stock prices go hand in hand.

A study of past history suggests that inflation is usually bullish up to a point. But every period of persistent inflation ultimately has led to speculation and then frenzied speculation. Out of frenzied speculation comes collapse. I feel that we are now at the dividing line between the frenzied speculation and collapse periods.

SPECULATIVE FUROR: The accompanying chart on page 4 (by Merrill Analysis, Box 228, Chappaqua, N.Y. 10514) tells an interesting story, or rather documents that story. It traces the ratio of Amex volume to N.Y.S.E. volume. For many years this ratio held between 10 and 30.

But note that the ratio careened into the above-60 area during March of 1966, at a time when the Industrial Average was caving in and the Low-Priced Stock Index was hitting new highs. The frenzied speculation in low-priced stocks during early 1966 proved to be the cover-up for massive distribution in blue-chip stocks. The result was an ultimate smash in the whole market.

Now, again, we see the Amex-N.Y.S.E. ratio climbing to almost 60, speculation is rampant, and again my feeling is that many high-quality stocks are under important distribution.




CONCLUSION: I believe this market is at the danger stage. In the past few weeks numerous "neighbors" have come into my office, asking for a "hot tip" on this or that stock or asking my opinion on some $3 Amex issue. This has not occurred since 1961. I feel that the last stragglers are now entering the market (usually the Amex) with that hot $500 or $1000 in their fist. Most want a piece of the action, and they would like to run their $500 into $1500 to help meet the cost of their increasing household bills.

Here are the danger signs as I see them. (1) Speculation is at high pitch. With the Dow Industrials below their highs, Barron's Low-Priced Stock Index jumped to a new high of 326 last week.

(2) People are buying stocks or justifying purchase of stocks for reasons of inflation. Instead of buying values or buying on the basis of forthcoming higher earnings, gamblers are moving in on penny issues for no other reason than that they "are going up." History suggests that this is the worst possible reason for entering the market.

(3) The Rail Average has not confirmed the new Industrial recovery high. The two Averages have been diverging for the past few weeks. The Advance-Decline ratio too, has failed to confirm Industrials and has been acting decidedly laggard.

(4) Odd-Lotters are selling less and less on a ratio basis. Over the past few days selling and buying have become almost even. Lower prices are therefore being treated as "bargains" by the odd-lot public, and this is not a healthy sign.

(5) Bond yields are in the stratosphere, offering tremendous competition to common stock yields. The yield spread in favor of high-grade bonds is now historically at its most adverse level ever.

(6) The Bond Average and the Utility Average have been hitting new lows daily. This is anything but a healthy sign for the rest of the market.

(7) The ratio of Amex-N.Y.S.E. volume is in the classic danger zone around 60. Volume on both exchanges has been excessive, indicative of abnormal trading interest on the part of the performance funds and the public. The previous-listed danger signals are all the more significant since they are occurring in an area of great volume and activity. From another standpoint, it is worth noting that it is taking greater and greater amounts of volume to put the Dow up each point. Actually, with volume averaging around 10 million shares daily, the Industrial Average is now only slightly above its August peak of 926.72, while Rails are well below their August highs of 274.49.

RAILS: Whenever one Average looks as poor as does the carrier Average today, I break down the Average into its components and try to figure why the weakness. In studying the 20 D-J Rail stocks, it becomes obvious that the weakness is now general. I have picked 8 of the 20 stocks at random, and here we see a number of toppy formations, such as those of DGR, DH and KSU. Others have just been marking time in long sideways line formations, and this type of pattern appears in the charts of CO and NFK. I would say that the current downtrend in the Rail Average is reflecting broad deterioration in individual rail issues. (Charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas).